United States Senate
Committee on Finance

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Statement of Sen. Chuck Grassley
Hearing, "Carried Interest Part III: Pension Issues."
Thursday, Sept. 6, 2007

Thank you, Chairman Baucus, for calling this hearing, our third hearing on the carried interest issue. The first two hearings examined the tax treatment of carried interest received by investment fund managers, like private equity firms. This hearing will focus on pension plan investments in those funds.

Earlier this year Chairman Baucus and I asked the GAO to look into pension plan investments in hedge funds. Since making that request, we have been studying the tax treatment of carried interest. One argument against making any changes is based on the concern that higher taxes on fund managers will be passed on to fund investors, like pension funds. In response, Chairman Baucus and I intend to update our request, asking the GAO to examine pension plan investments in hedge funds and other alternative investment funds, like private equity funds.

Also, I am glad Chairman Baucus scheduled today's hearing – why? To get the facts. Media reports and some of our preliminary findings indicate that pension plans only invest a small percentage of their portfolio in private equity and hedge funds. I look forward to hearing from our witnesses today who may be able to corroborate this fact. There are some outliers, however. That is, there are some pension plans that have an alarming amount of the plans' assets invested in these risky investments, and in funds that are not registered with the SEC. This gives me pause.

I hope our witnesses today will inform the committee about the decision-making and due diligence process associated with pension investments in private equity and hedge funds. This includes the thought process that is required of those representatives of the pension fund who serve in a fiduciary capacity.

The economics of the decision to invest plan assets in a particular investment must also be considered. Balancing risk and return and the cost associated with an investment in one financial instrument over another is an aspect that cannot be overlooked. Investment decisions are generally based on net returns. Net return means the gross earnings less fees and expenses. Economics 101 tells me if the expected rate of return of an investment is diminished, I might consider moving my investment elsewhere.

Let me be clear, I understand that when two sophisticated investors get together, these sophisticated investors enter into complex business and legal negotiations involving multiple economic variables. It may be difficult to discern whether a change in one variable will change the outcome of the negotiations. But a change in one variable will surely have an impact on the overall negotiation process. I intend to ask the panel to describe the negotiations that take place between a pension fund and, for example, a private equity fund manager.

I want to emphasize that I do not believe that pension plans should be prohibited from investing in private equity and hedge funds. A strong argument can be made that these investments round out a well-diversified and well-balanced investment portfolio. In addition, the capital that is provided through pension investments could have a positive effect on the economy. I do, however, think that plan fiduciaries must tread lightly when assessing the risk and return and the cost associated with these investments. Plan participants' retirement security depends upon it. I fear the day that a pension plan goes under because a hedge fund or sectors of the private equity industry go under. As we examine the taxation of carried interest with these concerns in mind, it is appropriate to ask the question: To what extent will a change in the way carried interest is taxed adversely affect pension plan participants? I look forward to our witnesses' testimony. And I look forward to getting the facts.